No. 88-1130

Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1988

NUTRI/SYSTEM, INC., HAROLD KATZ, MARTIN S. BEGUN, THOMAS W. L. CAMERON, A. DONALD McCULLOCH, JR., ALBERT J. DiMARCO, REEF C. IVEY, II AND JOHN E. SYLVESTER,
Petitioners,

v.

HENRY HERSKOWITZ, ALAN ROSMAN, JOSEPH FABIAN, NISSIM HUSNI, DONALD SUNSHINE and JACK POTOK and FRED POTOK, JOINT TENANTS, on behalf of themselves and all others similarly situated,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION OF NUTRI/SYSTEM, INC., HAROLD KATZ, MARTIN S. BEGUN, THOMAS W. L. CAMERON, A. DONALD McCULLOCH, JR., ALBERT J. DiMARCO, REEF C. IVEY, II, and JOHN E. SYLVESTER FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

In a case involving a leveraged buy-out by management of the shares of a controlling shareholder and all minority shareholders at a price greatly exceeding the New York Stock Exchange trading price, and a knowing rejection by the class plaintiffs of a statutory appraisal for fair value, should not this Court settle the following questions which, because they remain unresolved, have caused a proliferation of minority shareholder class actions:

1. Where there is no fraud on the market, does the trading price of stock actively traded on a major exchange conclusively establish its value for the purpose of federal securities claims and state law claims? (Differing legal significance of trading price given by 1st, 7th and D.C. circuits).

2. Should causation be presumed where a single shareholder has sufficient votes, without the votes of minority shareholders, to effectuate a merger? (Conflict in circuits noted by this Court in 1970 continues).

3. Should a knowing rejection by minority shareholders of a statutory appraisal remedy for fair value preclude a securities action for fair value? (This Court has thus far held only that the availability of the statutory appraisal is a factor to be taken into account in determining whether a private cause of action under §10(b) should be implied).

4. What is the proper standard for imposing liability for an opinion or projection? (Conflict among circuits).

PARTIES

The named petitioners were appellees below and defendants at trial. Connecticut National Bank, which has filed its own petition with this Court, was an

appellee and cross-appellant below and a defendant at trial. The following respondents, who were appellants and cross-appellees below, were plaintiffs in six consolidated class actions: Henry Herskowitz, Alan Rosman, Joseph Fabian, Nissim Husni, Donald Sunshine, and Jack Potok and Fred Potok, Joint Tenants, on behalf of themselves and all others similarly situated.

RULE 28.1 DISCLOSURE

Petitioner Nutri/System, Inc. hereby discloses, pursuant to Supreme Court Rule 28.1, that its parent is Diversified Services Group Inc. and that its subsidiaries are Nutri/System of Florida, Inc., Nutri/System of Georgia, Inc., Nutri/System (Bermuda) Ltd. and Nutri/System (Canada) Ltd. Nutri/System Inc. also has an ownership interest in many franchises, all trading as "Nutri/System," many of which have been separately incorporated by their franchisees under names too numerous to list here.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners Nutri/System, Inc., Harold Katz, Martin S. Begun, Thomas W. L. Cameron, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey II and John E. Sylvester respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in *Herskowitz, et al. v. Nutri/System, Inc., et al.*

OPINION BELOW

The opinion of the United States Court of Appeals for the Third Circuit is reported at 857 F.2d 179 (3d Cir. 1988) and appears in the attached appendix at pages A-1 through A-26.

JURISDICTIONAL STATEMENT

The United States Court of Appeals for the Third Circuit filed its opinion and judgment on September 13, 1988, and denied a timely petition for rehearing and rehearing in banc on October 11, 1988. (See attached appendix at A-1 and A-27). This petition is filed within ninety days of the denial of rehearing. Jurisdiction of this Court is based on 28 U.S.C. §1254(1).

STATUTES AND REGULATIONS

Sections 10(b) and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b) and 78n(a), as well as Rules 10b-5 and 14a-9, 17 C.F.R. §§240.10b-5 and 240.14a-9, promulgated thereunder, are set forth in the attached appendix at pages A-29 through A-31.

STATEMENT OF THE CASE

The instant securities fraud class action was instituted one day[1] following an announcement by Nutri/System, Inc. that its founder and controlling shareholder had agreed to sell all of his shares and the shares of all public shareholders to senior management. (Tr. 329; Ex. P-3, p. 25).[2] Consummation was conditioned upon approval of the shareholders at a special meeting to be held at a later date.

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1. The Court of Appeals erroneously states that "[t]he shareholders' suit was filed on August 1, 1986" (857 F.2d at 183; A-9). The suit was filed on February 6, 1986, one day following the merger announcement. (E.D. Pa. Dkt. 86-0711, p. 1). Subject matter jurisdiction was grounded on 15 U.S.C. §78aa and 28 U.S.C. §1331 and principles of pendent jurisdiction.

2. (References to "Tr." refer to the trial transcript; references to "Ex." refer to trial exhibits.) The Court of Appeals erroneously states that "Katz decided to sell *his share* of the company in 1984." (857 F.2d at 182; A-8) (emphasis added) Such a transaction was never contemplated.

Founder Harold Katz, who owned 58% of all shares, had actively marketed the company for several years. (Tr. 154-162; N/S Ex. 31). The price at which he agreed to sell ($70 million or $7.16[3] per share) was more than any other parties had offered and exceeded the $3.00-$5.75 range in which the shares had actively traded on the New York Stock Exchange in the previous year. He was to receive the same per share price as all shareholders. Dissenting shareholders were given the right to obtain, instead, "fair value" as determined by a statutory appraisal court. (Ex. P-3, at 52-53).

Five other class actions immediately followed. (Tr. 329; Ex. P-3, p.25). All six were virtually identical, averring violations of §10b of the Exchange Act and pendent state claims.

No proxy statement having yet been published, there followed a Motion to Dismiss on the ground that any claim of less than full disclosure was obviously premature. The motion was denied. (E.D. Pa. Dkt. 86-0711, entry 15). Five months later the final proxy statement was distributed. An evidentiary hearing was held on plaintiffs' motion to enjoin the shareholders' vote on the transaction. The motion was denied. At the shareholders meeting, the shareholders (and the minority shareholders) overwhelmingly approved the transaction, which was then consummated. (E.D. Pa. Dkt. 86-0711, entries 19 and 28; Tr. 332).

An Amended Complaint was filed, adding a §14(a) claim to the previous §10b claim. Following full discovery, defendants moved for summary judgment, on the ground of the statutory appraisal and causation issues raised in this Petition. The motion was denied. (E.D. Pa. Dkt. 86-0711, entry 83).

The case came to trial. Defendants moved to preclude expert value testimony on the ground that the

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3. It was agreed at trial that the value of the package offered all shareholders — $6.13 plus a subordinated debenture — was $7.16. (Jury interrogatories, p. 5; Tr. 1231).

New York Stock Exchange price was conclusive. The motion was denied. The jury answered special interrogatories[4] regarding alleged omissions and misrepresentations in the proxy statement in favor of all defendants. Judgment was entered for defendants. (Dkt. 86-0711, entry 113; jury interrogatories; Tr. 1323-26; A-28).

On appeal, the Court of Appeals, in a two to one decision, held that the trial judge erred in failing to permit the jury to decide whether the assumption of a future tax rate of 46% in an unpublished discounted cash flow analysis of the financial institution which opined on the fairness of the price, rendered its published fairness opinion false and misleading. Plaintiffs' expert, who agreed that the financial institution's opinion properly took into account many factors, including the trading price of the stock (Tr. 562), had testified that its discounted cash flow analysis contained errors (Tr. 506-509). One of the alleged errors was its assumption of a tax rate of 46% when it was common knowledge that tax rates would soon be lowered. The trial judge concluded that the tax rate used was disclosed in the proxy statement as was the fact that the Congress had

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4. "Did the proxy statement contain a *misrepresentation* of *material* fact because it included the fairness opinion of Connecticut National Bank?

"Did the proxy statement contain an *omission* of *material* fact because it did not include the projections developed by A. Donald McCulloch Jr. that included his prediction that there was a "55% chance of exceeding published figures by 20%?

"Does Exhibit P-24 accurately state a part of the contract between Connecticut National Bank and Nutri/System, Inc. concerning compensation to the bank for its services in rendering its fairness opinion?

"Did the proxy statement contain an *omission* of *material* fact because it did not state the terms of the contract between Connecticut National Bank and Nutri/System, Inc. set forth in Exhibit P-24?"

(Jury interrogatories 1-4) (emphasis in original).

before it the proposed changes (Tr. 1070), and did not submit that issue to the jury. The Court of Appeals, in reversing and remanding for a new trial,[5] held that recovery is permitted "when an expert, in making a projection, adopts an assumption which the factfinder concludes was objectively unreasonable in the circumstances". 857 F.2d at 185. (A-14). It did not address the defendants' arguments at trial and on appeal that the case should not have been submitted to the jury at all. (See note 6, *infra*.)

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

I. Securities fraud class actions for money damages with great *in terrorem* impact are proliferating in the federal courts because major issues, three of which are present in the instant case, remain unsettled.

In the instant case a *controlling shareholder* decided to sell the company for a price greatly *exceeding the last year's New York Stock Exchange price* and gave dissenters the option of receiving instead "fair value" as determined by a *statutory appraisal Court*. Nevertheless, within 24 hours of the announcement of the proposed transaction – five months before there even existed a proxy statement containing the disclosures which plaintiff claimed were inadequate – this and two other securities fraud class actions were instituted, followed within a week by three others.

The words italicized above identify three major issues[6] which, because they have remained unsettled for

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5. A second ground for the reversal and remand was an allegedly erroneous instruction in respect of the pendent state law claim. 857 F.2d at 185 *et seq.* (A-18). For reasons stated in section IA, a determination that the trading price is presumptively conclusive would dispose of the second ground as well.

6. The three issues raised in Section I of this Petition were preserved below as follows: The issue of the conclusive effect of the

many years, have caused minority shareholder class actions to proliferate. While this case is unusual in that it was tried to a defendants' verdict, such securities fraud class actions, because of their great *in terrorem* effect in combination with the regrettable uncertainty in the law, most often result in substantial undeserved settlements.

A. Where the merger price exceeds the trading price of stock actively traded on a major exchange, the exchange price should be deemed presumptively conclusive, i.e., conclusive absent evidence of fraud on the market or other evidence undermining the exchange price as a determinant of value.

The Courts of Appeal have given different levels of legal significance to the price at which a stock actively trades on a public exchange, holding variously that the price is "conclusive" of its value or "presumptive" of its value, or that it is the best, or strong, evidence of value, or that it is an appropriate "guide" in ascertaining value.[7]

NOTES *(Continued)*

trading price was raised, *inter alia,* at trial by oral motions at side bar, each of which was denied (Tr. 477-82, 555, 589), as well as in petitioners' motion for directed verdict (p. 6, ¶26) denied by the court, and in a proposed supplemental jury instruction rejected by the court. On appeal, petitioners raised the issue at pp. 1-2 of its petition for rehearing. The controlling shareholder issue was raised, *inter alia,* in petitioners' proposed jury instruction no. 86 (rejected), in their motion for directed verdict at ¶¶11 and 22, and brief, p. 12 (denied), in a note following their proposed interrogatories (rejected) and in their petition for rehearing on appeal at pp. 11-12. The statutory appraisal issue was raised in petitioners' motion for directed verdict (pp. 6, 11 & 12) and in proposed jury instructions 8(c) and 9(d) (rejected). On appeal, that issue was raised in petitioners' brief at pp. 36-40 and in pages 4-13 of their petition for rehearing.

7. *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir. 1977), *cert. denied*, 434 U.S. 922 (1977), *reh. denied*, 434 U.S. 1002 (1977) ("we hold that when market value is available and reliable, *other factors should not be utilized* in determining whether the

This Court has addressed that issue only by implication in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972) (when determining fair value of corporate stock in "isolated" and "thin" market, fact-finder not restricted to actual sales price) and in *Basic v. Levinson*, U.S. , 108 S.Ct. 978, 990-996 (1988).

In the instant case, no evidence was offered of previous fraud or manipulation that might have skewed the trading price on the exchange or that in any way undermined the validity of the market itself as a valid indicator of value. The evidence that the stock was

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terms of a merger were fair"); *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826 (7th Cir. 1985) ("the price of stock in a liquid market is *presumptively* the one to use in judicial proceedings"); *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, 600 F.2d 355, 361-62 (2d Cir. 1979) ("the rule derives from the 'efficient market theory,' which, briefly stated, is that in a free and actively traded market, absent compelling reasons to believe otherwise, the market price is held to take account of asset value as well as the other economic, political, and financial factors that determine 'value.' ") In another context (the determination of "value" for income tax purposes), *Amerada Hess Corporation v. Commissioner of Internal Revenue*, 517 F.2d 75, 84 (3d Cir. 1975), *cert. denied*, 423 U.S. 1037 ("where . . . the property to be valued consists of securities traded on a stock exchange, the general rule is that the average exchange price quoted on the valuation date furnishes the most accurate, as well as the most readily ascertainable, measure of fair market value . . . [W]e are of the opinion that the fair market value of the shares . . . *was conclusively established* by the evidence of the sales which took place on the Curb Exchange on that day", citing cases from various circuits); *Holmes v. Bateson*, 583 F.2d 542, 563 (1st Cir. 1978) (market price is "*best evidence*" when available and reliable); *Southern Pacific Transportation Co. v. I.C.C.*, 736 F.2d 708, 726 (D.C. Cir. 1984), *cert. denied* 469 U.S. 1208 (1985) (affirming use of the stock market price as a "*guide*" in ascertaining value); see *Borg v. International Silver Co.*, 11 F.2d 147, 152 (2d Cir. 1925) (L. Hand, J.) ("When all is said, value is nothing more than what people will pay for the shares, given as wide an opportunity for bidders to come in as is reasonably possible"). (Emphasis throughout added).

heavily traded over an extended period on a major exchange (Tr. 613-620) was totally unrebutted. Where that is the case, the exchange price should be conclusive. We note that such a ruling would apply to damage actions beyond those in the securities fraud field (see cases in note 7 above), and would dispose as well of the pendent state action in the instant case (predicated on a claim that a price that is less than fair value would in itself be an adequate basis for a jury to find a breach of the fiduciary obligation not to engage in unfair self-dealing. 857 F.2d at 185, A-14.)

B. When a controlling shareholder is alone able to effectuate a merger and receives the same price per share as minority shareholders, the causation requirements for a money damage action under the securities laws are not satisfied.

This Court nineteen years ago noted the contrariety of federal decisions on the question whether the causation requirements of §14(a) can be met where (as here) a single shareholder, through his votes alone, can effectuate the merger. *Mills v. Electric Auto-Lite Company*, 396 U.S. 375, 385 n. 7 (1970) ("We need not decide in this case whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority. . . .") and cases cited therein. That question remains open,[8] and should be settled by this Court.

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8. Cases noting the conflict but determining that the issue need not be decided in the particular case: *Ash v. LFE Corp.*, 525 F.2d 215, 217, n. 2 (3d Cir. 1975); *Fradkin v. Ernst*, 571 F. Supp. 829, n. 7 (N.D. Ohio 1983); *Lewis v. Bogin*, 337 F. Supp. 331, 337 (S.D. N.Y. 1972). Cases holding no causation where there is a controlling shareholder: *Bruno v. Cook*, 660 F. Supp. 306, 308-309 (S.D. N.Y. 1987); *Hanover v. Zapata Corp.*, CCH Federal Securities Law Reporter, ¶93, 904 (S.D. N.Y. 1973); *Ross v. Longchomps, Inc.*, 336 F. Supp. 434, 440 (E.D. Mo. 1971). Cases implying no causation: *Dasho v. Susquehanna Corp.*, 461 F.2d 11 (7th Cir.

C. Damage actions for "fair value" under the federal securities laws as an alternative to the statutory appraisal remedy for "fair value" in corporate mergers, are unnecessary and should not be implied.

This Court has held that a private right of action under §§10b and 14(a) is to be implied *when necessary*.[9] In *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), the existence of a statutory appraisal remedy was a principal reason why this Court held that no private cause of action would be implied (Part IV of Opinion, 430 U.S. at 478). It was only one of several reasons given for that conclusion, and the trial judge in the instant case declined to grant summary judgment or to grant the undersigned's Rule 50(b) motion on the authority of that decision.

We urge upon this Court a more definitive ruling: that an action for money damages under the securities laws should not be implied where, as in the instant case,

- there is a statutory appraisal remedy,

1972), *cert. denied*, 408 U.S. 925 (1973); *National Home Products, Inc. v. Gray*, 416 F. Supp. 1293 (D.C. Del. 1976). Cases holding causation not presumed where there is a controlling shareholder, but may be proved with other evidence: *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381, 383 (2d Cir. 1974), *cert. denied* 421 U.S. 976; *Swanson v. American Consumer Industries, Inc.*, 475 F.2d 516, 518, n. 2 (7th Cir. 1973); *Cole v. Schenley Industries, Inc.*, 563 F.2d 35 (2d Cir. 1977); *Smillie v. Park Chemical Co.*, 466 F. Supp. 572, 577-578 (E.D. Mich. 1979); *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1248-1249 (D.C. Del. 1978); *Evmar Oil Corp. v. Getty Oil Co.*, CCH Federal Securities Law Reporter, ¶96, 358 (C.D. Cal. 1978).

9. *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13, n. 9 (1971); *J. I. Case Co. v. Borak*, 377 U.S. 426, 431-433 (1964); *Piper v. Chris-Craft Industries*, 430 U.S. 1, 41 (1977) *reh. denied*, 430 U.S. 976 (1977); *Santa Fe Industries v. Green*, 430 U.S. 462, 477 (1977).

• defendants have not impeded plaintiffs from pursuing that appraisal remedy[10] (see *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980)),

• and the damages sought are precisely those provided through an appraisal – i.e., "fair value".

It is of utmost importance to note how and why class action suits under the securities laws are crowding out statutory appraisals as the plaintiff class action bar's remedy of choice. In a statutory appraisal the shareholders receive *only* "fair value", even if the proferred merger price which they rejected was much higher. The downside risk of an award less than the merger price is entirely eliminated in a suit under the securities laws, where the plaintiff shareholder receives the proferred consideration and then seeks the difference between it and the purportedly higher "fair value" from a federal jury. If he loses, as was the case here, or if he wins but a jury determines that the fair value of the shares was less than the amount he received, he will never have to return anything. The existence of such an attractive, cost-free federal alternative to a statutory appraisal is effectively eliminating the appraisal remedy created by the states.

Here, the class actions were instituted long before there even existed a proxy statement for plaintiff to examine and determine whether disclosure was full and complete; thus it was clear from the outset that the issue was not fraud but price.

No private cause of action for damages *need* be implied in such circumstances, and therefore none should be.

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10. Plaintiff pleaded that the "corporate mechanics necessary to pursue any other remedy, such as appraisal, would require substantial expense, delay and time." First Joint Amended and Supplemental Complaint, ¶25.

II. This Court should settle the question of the appropriate standard for determining liability for the publication of projections and opinions.

A. The standard applied in the instant case creates a conflict among the circuits.

A number of courts of appeal have developed similar, not identical, standards for determining when an opinion[11] or a projection[12] can be a false or misleading statement under the securities laws.[13]

The standard employed by the Court of Appeals in the instant case differs from all of them, and conflicts as well with fundamental principles enunciated by this Court, in the manner set forth below. This Court should

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11. *Opinions: Eisenberg v. Gagnon,* 766 F.2d 770, 776 (3d Cir. 1985), *cert. denied, Wasserstrom v. Eisenberg,* 474 U.S. 946 (1985) (opinion actionable if issued "without reasonable genuine belief or if it had no basis"); *SEC v. Okin,* 137 F.2d 862, 864 (2d Cir. 1943) (opinion that operation of subsidiaries caused losses held false because there was "no ground" for opinion).

12. *Projections: Isquith v. Middle South Utilities, Inc.,* 847 F.2d 186, 203 (5th Cir. 1988) *cert. denied,* ____ U.S. ____, 109 S. Ct. 310 (1988) (whether a predictive statement is "false" when made, is determined by examining the nature of the prediction, "with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis". To same effect, *Luce v. Edelstein,* 802 F.2d 49, 56 (2nd Cir. 1986), and *Polin v. Conductron Corp.* 552 F.2d 797, 806 n. 28 (8th Cir. 1977) *cert. denied,* 434 U.S. 857 (1977). *Marx v. Computer Sciences Corporation,* 507 F.2d 485 (9th Cir. 1974) (earnings forecast false if opiner "did not then believe earnings would be in that amount or knew that there was reason to believe they would not be"; forecast "implies a reasonable method of preparation and a valid basis"); *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1040 (7th Cir. 1977), *cert. denied,* 434 U.S. 875 (1977) (earnings projection actionable because defendants knew or were recklessly indifferent in not knowing that they were grossly inflated).

13. As will be seen in the text, what is involved in this case is an opinion which was based in part on existing facts and in part on a projection.

clarify and provide much needed uniformity in what has recently been described as a "complicated and evolving area of securities law." *Isquith v. Middle South Utilities, Inc.*, 847 F.2d 186, 203 (5th Cir. 1988), *cert. denied*, ____ U.S. ____, 109 S. Ct. 310 (1988).

B. The standard applied in the instant case permits liability regardless of the truth or falsity of the statement made and regardless of full disclosure.

In all of the cases cited in notes 11 and 12, the court focused on an allegedly misleading "statement of material fact,"[14] whether an opinion or projection, and correctly asked the question whether *that statement* had a reasonable basis. In the instant case the court determined that liability could be imposed if there was no reasonable basis for an assumption (the 46% tax rate) underlying an unpublished cash flow analysis which itself was only one of the bases for the published opinion. The difference is profound, and greatly expands the liability of financial institutions under the securities laws.

The "statement" whose truth or falsity under §§10 and 14 was at issue in this case, was not the financial institution's discounted cash flow analysis, which was never published, but its written opinion, in the proxy statement, "that the consideration per share . . . to be received by the Company's shareholders is fair from a financial point of view as of the date of this letter."

That opinion was based on many factors (Tr. 393, 405-6, 834, 871, 901) including the undisputed fact that the per share consideration, $7.16, was much higher than the stock's $3.00-5.75 trading price range on the New York Stock Exchange in the year preceding the merger agreement, and the undisputed fact that the

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14. Both Rule 10b-5 and Rule 14a-9 refer to a "statement" of a material fact which is untrue, or which is misleading because of the omission of a material fact.

total consideration paid, $70 million, was much higher than the amount any other party had been willing to pay during the two years preceding the merger, when the company had been actively marketed, and the fact (disputed by plaintiffs) that a proper discounted cash flow analysis, based on projections of future performance, would produce a range of fairness of $6.50-$8.50. *None of this information was published*[15] in the opinion letter which simply opined that "the consideration . . . is fair from a financial point of view . . ."

Plaintiff did not challenge the validity of any of the factors on which the opinion rested except the discounted cash flow analysis based on projections of future performance.

In shifting the focus of inquiry from whether *the statement made* was misleading, as required by the express language of both Rules 10(b)-5(b) and 14a-9, to whether there was a reasonable basis for an assumption that underlay one of numerous factors supporting the statement made, the Court of Appeals sharply deviated from the standard in all circuits that have spoken on the subject, including the standard previously adopted by the Third Circuit in *Eisenberg v. Gagnon,* 766 F.2d 770 (3d Cir. 1985), *cert. denied, Wasserstrom v. Eisenberg,* 474 U.S. 946 (1985).

The correct standard should be and heretofore had been that a published opinion or projection must have a reasonable basis. Elsewhere in this Petition (IA) we note the conflict among the circuits over the legal import of the trading price of stock on a major exchange. Here, the per share merger price was much higher than the New York Stock Exchange trading price. Whether that fact "conclusively" establishes that the price was fair, as

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15. The Court of Appeals erroneously stated that the bank "issued a fairness opinion stating that the $7.16 a share price was fair to shareholders because the company was worth between $6.50 and $8.50 a share." 857 F.2d at 183 (A-9).

some courts of appeal have held, or is only the best evidence of value, as other courts of appeal have held,[16] it obviously provides the requisite reasonable basis. The standard articulated in the instant case permits the imposition of liability for a statement that is neither false, reckless, or even wrong.

Moreover, the tax rate issue was not submitted to the jury by the trial judge because the proxy statement disclosed that a 46% tax rate was used in the projections contained therein and that the United States Congress was in the process of considering a change in that tax rate which might impact on value. The court of appeals concluded that he had not analyzed the issue correctly. It was, however, the court of appeals that wrongly analyzed the issue, for permitting a jury to find liability where there has been full disclosure is an unwarranted extension of §§10 and 14 in direct contradiction of *Sante Fe, supra* and *J. I. Case Co. v. Borak,* 377 U.S. 426, 431 (1964).

In sum, when a plaintiff establishes only that one of numerous tests rested upon an unreasonable assumption, and evidence of all other factors supporting the opinion remains unrebutted, he has demonstrated, perhaps, negligence in some abstract way, but not the culpability required under §10. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), *reh. denied,* 425 U.S. 986 (1976). Even more fundamentally, under both §10 and §14, a plaintiff must establish that *some statement* was misleading. The new standard created by the Court of Appeals in this case conflicts with the standards in other

16. See cases cited at note 7, above.

circuits in permitting liability a) where there is no misleading statement whatsoever, and b) where there has been full disclosure.

CONCLUSION

For all of the foregoing reasons, petitioners respectfully pray that an appropriate writ of certiorari be issued.

Respectfully submitted,

MANN AND UNGAR, P.A.

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DATED: January 7, 1989

APPENDIX

Henry HERSKOWITZ, on behalf of himself and all others similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Henry HERSKOWITZ, Appellant No. 87-1786 Connecticut National Bank, Cross-Appellant No. 87-1798.

Alan ROSMAN, on behalf of himself and all others similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Alan ROSMAN, Appellant No. 87-1787 Connecticut National Bank, Cross-Appellant No. 87-1799.

Joseph FABIAN, on behalf of himself and all others similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Joseph FABIAN, Appellant No. 87-1788 Connecticut National Bank, Cross-Appellant No. 87-1800.

Nissim HUSNI, on behalf of himself and all others

similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Nissim HUSNI, Appellant No. 87-1789 Connecticut National Bank, Cross-Appellant No. 87-1801.

Donald SUNSHINE, on behalf of himself and all others similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Donald SUNSHINE, Appellant No. 87-1790 Connecticut National Bank, Cross-Appellant No. 87-1802.

Jack POTOK, Fred Potok, Joint Tenants, on behalf of themselves and all others similarly situated

v.

NUTRI/SYSTEM, INC., Harold Katz, A. Donald McCulloch, Jr., Albert J. DiMarco, Reef C. Ivey, II, Duane E. Jarvis, Norman Amster, Martin S. Begun, Merrill Lynch Capital Markets, Inc., Connecticut National Bank, John E. Sylvester, Thomas W.L. Cameron.

Appeal of Jack POTOK and Fred Potok, Appellants No. 87-1791 Connecticut National Bank, Cross-Appellant No. 87-1803.

Nos. 87-1786 to 87-1803.

United States Court of Appeals,
Third Circuit.

Argued June 21, 1988.

Decided Sept. 13, 1988.

Rehearing and Rehearing In Banc
Denied Oct. 11, 1988.

Shareholders brought class action challenging terms of leveraged buyout and adequacy of proxy statement. The United States District Court for the Eastern District of Pennsylvania, Louis Charles Bechtle, J., entered judgment on jury verdict in favor of shareholders, and defendants appealed. The Court of Appeals, Gibbons, Chief Judge, held that: (1) jury could have found that investment banker's use of 46% tax rate assumption in issuing fairness opinion was not improper; (2) statutory appraisal right under Pennsylvania law co-exists with common-law cause of action; (3) proxy statement would not have been read by reasonable investor as indicating that leveraged buyout was a result of arms length negotiations; (4) evidence of proposed merger performance was properly excluded; and (5) investment banker need not have intent to deceive or cheat in order to be held liable.

Reversed and remanded.

James Hunter, III, Circuit Judge, dissented and filed an opinion.

1. Securities Regulation 49.21

Opinion or projection, like any other representation, will be deemed untrue for purposes of the federal securities laws if it is issued without reasonable genuine belief or if it has no basis.

2. Securities Regulation 49.22(10)

Fact that proxy statement informed stockholders that tax laws might change, thus affecting desirability of leveraged buyout, did not preclude finding that opinion on unfairness of the transaction issued by bank was misleading because of its tax law assumptions, as the fairness opinion had independent significance to the shareholders.

3. Securities Regulation 49.29

Evidence was sufficient to permit jury to find that bank's use of a 46% effective tax rate when issuing fairness opinion with respect to leveraged buyout was a reasonable choice and thus not the basis for liability of the bank to shareholders, even though Congress was in the process of adopting new tax laws.

4. Corporations 314(1)

Fact that corporate officers are not found to have made inadequate disclosure to shareholders in connection with proposed leverage buyout does not preclude finding of self-dealing and breach of fiduciary duty.

5. Corporations 190, 320(1), 584

Pennsylvania statutory appraisal cause of action for shareholders with respect to merger or buyout coexists with common-law causes of action against majority shareholders or officers. 15 P.S. §1515, subd. K.

6. Securities Regulation 49.21

Section of proxy statement which said that proposed purchaser indicated to majority shareholder that he and other members of senior management were interested in structuring a leverage buyout of the company and that discussions took place did not mislead shareholders into

believing that the leverage buyout was the result of arm's length negotiations.

7. Evidence 146

Although evidence of postmerger performance of corporation may have been relevant to issue of adequacy of proxy statement, it was not an abuse of discretion to exclude it on the grounds that its possible prejudice would outweigh any probative value. Fed.Rules Evid. Rule 403, 28 U.S.C.A.

8. Federal Courts 635
Federal Civil Procedure 2236

Parties are deemed to have waived any objection to interrogatories unless those objections are made known to the court before the jury retires. Fed.Rules Civ.Proc. Rule 49(a), 28 U.S.C.A.

9. Federal Civil Procedure 2236

Trial court's wording of special verdict interrogatories in action challenging adequacy of proxy statement in connection with leveraged buyout was adequate, notwithstanding contentions that it might confuse the jury on the standard of fraudulence of an opinion, might mislead the jury as to the identify of the defendants to whom certain standards were attributable, and would mislead the jury as to the nature of the fee arrangements involved.

10. Securities Regulation 49.26(2)

Intent to deceive or cheat is not necessary to establish liability of outside professional, such as investment banker, rendering opinion in connection with merger. Securities Exchange Act of 1934, §14(a), 15 U.S.C.A. §78n(a).

11. Securities Regulation 49.26(2)

Material misrepresentation, even when made negligently rather than intentionally or recklessly, can still inflict anticipated harm and thus can be actionable. Securities Exchange Act of 1934, §14(a), 15 U.S.C.A. §78n(a).

12. Securities Regulation 49.25(1)

Investment banker rendering a fairness opinion in connection with a leveraged buyout is held to the same standard of liability in connection with statements which it makes to shareholders as is the management it is assisting. Securities Exchange Act of 1934, §14(a), 15 U.S.C.A. §78n(a).

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Theodore R. Mann (argued), Marc J. Zucker, Mann & Ungar, Philadelphia, Pa., for appellees Nutri/System, Inc. Harold Katz, Martin S. Begun & Thomas W.L. Cameron.

Before GIBBONS, Chief Judge, and HIGGINBOTHAM and HUNTER, Circuit Judges.

OPINION OF THE COURT

GIBBONS, Chief Judge.

Shareholders of Nutri/System, Inc., who are plaintiffs in six consolidated class actions challenging the terms of a leveraged buyout, appeal from a judgment in favor of the defendants. The defendants include the Corporation, its senior management which purchased Nutri/System's business, its board of directors, and Connecticut National Bank, which issued an opinion letter on the fairness of the transaction. The shareholders challenged the leveraged buyout on the ground that its approval by shareholders was procured by use of a materially false and misleading proxy statement in violation of sections 10(b) and 14(a) of the Securities Exchange Act of 1934. 15 U.S.C. §§78j(b) and 78n(a). They also alleged that the buyout was at an unfair price in violation of Pennsylvania law which breached fiduciary duties owed by its officer and directors to Nutri/System's public shareholders. Connecticut National Bank has filed a protective cross appeal contesting the standard of care on which the plaintiffs' claim against it was submitted to the jury. We conclude that two trial errors require a new trial. Since we will remand for a new trial it is appropriate to address and reject other claimed errors.

I

Nutri/System, founded in 1972 by Harold Katz, operates and franchises weight-loss centers. From a single weight-loss center in Philadelphia, Nutri/System had grown by 1983 to a nationwide chain of 70 centers producing annual revenues of $133 million. In that year a secondary public stock offering was made by Katz, who retained a majority interest. Soon thereafter the company experienced a decline in its fortunes, including litigation with some of its franchisees. A settlement of this litigation reduced Nutri/System profits on sales of

food products to franchisees, and competition in the industry put pressure on revenues. Katz decided to sell his share of the company in 1984. A proposed sale of the whole company to an acquisition group at approximately $9.00 a share ($90 million) fell through early in 1985, when the acquisition group was unable to obtain adequate financing. By the spring of 1985 the management was demoralized, and Nutri/System stock was trading at less than $4.00 a share.

In March, 1985 Katz hired A. Donald McCulloch, Jr. as president of Nutri/System. McCulloch had a strong record in revitalizing other foundering companies, and he hired Albert J. Di Marco in marketing, Reef C. Ivey for administration and as General Counsel, and John E. Sylvester for operations. These three, with McCulloch, eventually made the leveraged buyout. During the negotiations with McCulloch over his employment, Katz promised that if he decided to sell Nutri/System McCulloch would have the right to make an offer.

In November, 1985 Katz offered to sell Nutri/System to McCulloch's group for $70 million, which would yield approximately $7.00 a share for all shareholders. The stock was then selling at about $4.00 a share, no offers from outside the company were pending, and its business was still on a downtrend. Merrill Lynch Capital Markets was retained to provide financial advice and assistance in raising the cash which Katz desired. After performing a due diligence investigation Merrill Lynch proposed in January, 1986 that the transaction be financed by $40 million in senior notes financed by Merrill Lynch, $20 million in cash in the Nutri/System treasury, $10 million in subordinated debentures issued to the shareholders, and $5 million in equity funds invested by the McCulloch group. The purchasers and their wives were able to borrow $2 million on the security of their homes and other assets, but could not find venture capital for the $3 million shortfall. Merrill Lynch then restructured the transaction by increasing

the senior note underwriting to $45 million, with detachable warrants entitling the senior noteholders to acquire 35% of the new company within five years. Under the restructured transaction existing Nutri/System shareholders would receive $7.16 a share.

In January, 1986 the Company appointed Thomas Cameron and Dr. Martin Begun, the only two members of the board of directors not personally involved in the buyout, to investigate its fairness. Cameron and Begun retained Connecticut National Bank to prepare a fairness opinion on a negotiated fee for service basis. The agreement, according to the proxy statement, provided that Connecticut National Bank would receive $50 thousand for its opinion and an additional $25 thousand if it were published. To evaluate the fairness of the $7.16 a share price Connecticut National Bank made a discounted cash flow analysis in appraising Nutri/System's value. That analysis was based on cash flow projections made by the McCulloch group. Certain downward adjustments were made to the McCulloch group's projections to eliminate risks. Connecticut National Bank also assumed, for purposes of the discounted cash flow analysis, that Nutri/System's income would continue to be taxed for the next five years at the then-existing 46% corporate tax rate. In February of 1986 Connecticut National Bank issued a fairness opinion stating that the $7.16 a share price was fair to shareholders because the company was worth between $6.50 and $8.50 a share.

A proxy statement was filed with the Securities and Exchange Commission in April of 1986. After several revisions, it was mailed to Nutri/System's shareholders on July 11, 1986, for a vote at a shareholders meeting on August 6, 1986.

The shareholders' suit was filed on August 1, 1986, seeking preliminary and permanent injunctive relief against the leveraged buyout. A motion for a preliminary injunction against holding the shareholders meeting was denied. The shareholders voted overwhelmingly in

favor of the proposed sale, and the leveraged buyout was closed on August 13, 1986.

Thereafter an amended complaint was filed and the case proceeded to trial before a jury. The district court during the trial precluded the shareholders from introducing any evidence relating to Nutri/System's performance following the buyout. Before submitting the case to the jury the district court partially granted defendants' Fed.R.Civ.P. 50(a) motion by removing certain issues raised by the shareholders from consideration by the jury. The case was submitted to the jury on special verdict interrogatories the answers to which favored the defendants. Judgment was entered in favor of the defendants, and these appeals followed.

II

While the shareholders claim numerous trial errors, we find only two which require a new trial.

A.

The Directed Verdict on Use of a 46% Tax Rate Assumption

The parties agree that the district court in effect granted defendants a directed verdict on the shareholders' contention that in selecting to project a 46% tax rate for 5 years Connecticut National Bank made an unreasonable choice. A more realistic choice, according to the shareholders, would have produced a significantly higher projected cash flow and thus a significantly higher valuation than $7.16 a share. Under Fed.R.Civ.P. 50(a) a "directed verdict may be granted only if, as a matter of law, viewing all the evidence which has been tendered and should have been admitted in the light most favorable to the party opposing the motion, no jury could decide in that party's favor." *Indian Coffee Corp. v. Procter & Gamble Co.*, 752 F.2d 891, 894 (3rd Cir.), *cert. denied*, 474 U.S. 863, 106 S.Ct. 180, 88 L.Ed.2d 150 (1985). There must be "sufficient evidence to submit to

the jury for the purpose of resolving conflicts in the evidence or inferences permissibly drawn from the evidence, or both." *Edward J. Sweeney & Sons, Inc. v. Texaco, Inc.*, 637 F.2d 105, 116 (3d Cir. 1980), *cert. denied*, 451 U.S. 911, 101 S.Ct. 1981, 68 L.Ed.2d 300 (1981). This court exercises plenary review of the grant of a directed verdict. *Indian Coffee Corp.*, 752 F.2d at 894; *Finkle v. Gulf & Western Mfg. Co.*, 744 F.2d 1015, 1021 (3d Cir. 1984).

[1, 2] An opinion or projection, like any other representation, will be deemed untrue for purposes of the federal securities laws if it is issued without reasonable genuine belief or if it has no basis. *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir.), *cert. denied*, 474 U.S. 946, 106 S.Ct. 343, 88 L.Ed.2d 290 (1985). *Accord, Gottreich v. San Francisco Investment Corp.*, 552 F.2d 866, 867 (9th Cir. 1977) (treating as actionable an opinion without adequate or reasonable basis); *S.E.C. v. Okin*, 137 F.2d 862, 864 (2d Cir. 1943) (treating as actionable an opinion for which there was "no ground"). *Cf. First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952, 98 S.Ct. 1580, 55 L.Ed.2d 802 (1978); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489-90 (9th Cir. 1974) (treating opinions as actionable where there was a gross disparity between them and the facts). The district court based its decision to remove the assumed tax rate issue from the jury on the fact that the proxy statement includes the following statement:

> Pending or Proposed Tax Legislation. The United States Congress is currently considering various tax reform proposals. Among the various proposals are provisions which, if enacted, would reduce ordinary income tax rates for both individuals and corporations, increase tax rates on capital gains, and strengthen the minimum tax and alternative minimum tax. If any such legislation is enacted, whether

such changes would affect particular items of income or loss discussed below could depend on the effective dates chosen by Congress.

Thus the district court based its ruling not on the reasonableness of Connecticut National Bank's projections in its fairness opinion, but on the disclosure in the proxy statement that the tax law might change. Concentrating on the notice of possible tax reform, the district court failed to address the separate issue of possible fraudulence in the fairness opinion itself. The fairness opinion had independent significance to shareholders, for it was obtained by the disinterested directors for the purpose of determining whether the offer from management was fair. It was, moreover, an opinion of an expert on valuation. Indeed, Connecticut National Bank impliedly recognizes that the district court's basis for removing the question from the jury is irrelevant, when it argues that "to overturn the trial court's directed verdict, plaintiffs must demonstrate that there was more than a scintilla of evidence that CNB either did not genuinely believe in the propriety of its use of a 46% tax rate in calculating the fairness of the $7.16 price per share offered by Nutri/System's management or that CNB had no sound factual or historical basis for the use of the 46% rate." Cross Appellant's brief p. 36. Thus, we must examine the evidence presented by the stockholders on the reasonableness in July of 1986 of a projected cash flow valuation using the 46% tax rate assumption.

[3] The shareholders' expert witness, John B. Torkelson, testified that it was inappropriate, in presenting a fairness opinion in July of 1986, to project a 46% effective tax rate over five years because "it was generally recognized by knowledgeable people in the field of financial analysis by July 1986 that the tax reform legislation pending before Congress was virtually certain to become law; that corporate income tax rates would be reduced to between 33 and 36 percent; and, that if CNB

had used a tax rate in the 33 to 36 range in its discounted cash flow analysis, . . . the range of values for the company would be from $7.58 to $10.35 per share," rather than a range which included $7.16. J.A. at 699, 2073. Torkelson pointed out that by the summer of 1986 "articles throughout the financial press were all saying the same thing, which is that the House bill is one rate, the Senate bill is another rate, they are extremely close, they are going to compromise and the bill will take effect on July of 1987." J.A. 739-40. Employees of the Connecticut National Bank who worked on the fairness opinion testified that they were aware of the impending tax reforms. J.A. at 891, 997, 1027. Nutri/System management in preparing its budget took into account the fact that tax rates would change effective July 1, 1987. Exhibit No. 29, J.A. 1912.

There was conflicting evidence as well. An employee of Connecticut National Bank, Kathy Fagan, noted the confusion and uncertainty surrounding the expected effects of tax reform, J.A. 996-97, and the fact that Nutri/Systems had paid in excess of a 46% rate over the prior five years when state and local taxes and amortization were included, J.A. 222. There was, moreover, evidence that Nutri/System paid total taxes amounting to 45% in the first year under the new tax law. J.A. at 743. The defendants urge that despite the evidence presented by the stockholders the conflicting evidence establishes as a matter of law that the fairness opinion is not actionable.

The opposing parties disagree over the meaning of the *Eisenberg v. Gagnon* test for the actionability of misrepresentations in an opinion or projection. The defendants contend that the shareholders cannot prevail unless they establish that there was no historical basis in fact for the 46% rate. If there is (and obviously there is), then Connecticut National Bank's decision to project that rate rather than others which might have been chosen for projection is unactionable as a matter of law.

The shareholders, on the other hand, define the *Eisenberg v. Gagnon* issue as whether the *selection* of the 46% rate among others that could have been selected was reasonable in light of all the evidence, including expert opinion evidence that financial experts were at the time relying on a much lower projected tax rate.

In *Eisenberg v. Gagnon* we held that projections are actionable if "issued without a genuine belief or reasonable basis," 766 F.2d at 776, thus articulating both a subjective ("without genuine belief") and an objective (without "reasonable basis") test. Given that the test is intended to identify deviations from the appropriate standard of care in expressions of opinions by professionals "with greater access to information or having a special relationship to investors making use of the information," *Eisenberg,* 706 F.2d at 776, the more reasonable interpretation of the rule is that it permits recovery when an expert, in making a projection, adopts an assumption which the factfinder concludes was objectively unreasonable in the circumstances.

Applying the *Eisenberg* test to the evidence referred to above, we hold that it is sufficient to present a jury question as to whether it was reasonable for Connecticut National Bank to render a fairness opinion in July of 1986 based on a cash flow projection which assumed a 46% tax rate for the next five years. The Court erred, therefore, in directing a verdict on this issue.

B.

The Instruction on the Pendent State Law Claim.

The shareholders' pendent state law claim for breach of fiduciary duty asserts that if the jury found the consideration for the leveraged buyout to be in fact unfair, Pennsylvania law would permit recovery from the fiduciaries for their unfair self dealing. The Court refused to instruct the jury to that effect, and the

shareholders' objection to the instruction in this respect was preserved. J.A. at 1479. The defendants make two responses to this contention.

[4, 5] The first response is that the state law claims are not independent of the federal law claims which were decided in their favor because the shareholders allege no additional claims of bad faith beyond those litigated in the federal securities claims. We reject this response. The gravamen of the federal claims, for liability purposes, is inadequate disclosure. The gravamen of the state law claim pressed by the stockholders is unfair consideration resulting from self-dealing by fiduciaries. Clearly the jury did not reach and decide the question of fairness of the consideration in disposing of the federal non-disclosure issues. The defendants' second response is more troublesome, namely, that section 515 K of the Pennsylvania Business Corporation Law excludes any post-merger remedy other than an appraisal proceeding, including even a federal private right of action. Thus, defendants urge, even the section 10(b) and 14(a) federal claims should not have gone to the jury. The statute on which this response is predicated provides:

> Any shareholder, who desires to object to, or dissent from, any proposed plan authorized under any section of this act, and where this act provides the shareholders so objecting or dissenting shall have the rights and remedies herein provided, shall be limited to the rights and remedies prescribed under this section, and the rights and remedies prescribed by this section shall be exclusive.

15 P.S. §1515 K (Purdon 1967). The rights and remedies referred to in section 515 K are the rights of dissenting shareholders to demand an appraisal of the fair value of their stock and to have it purchased by the corporation. The defendants interpret section 515 K to exclude all post-merger remedies, including remedies for misrepresentation and for breach of fiduciary duty.

We note that this action was commenced at the pre-merger stage, and that preliminary injunctive relief was denied on the ground that an adequate damage remedy could be fashioned for the shareholders. Another provision of the Pennsylvania Business Corporation Law provides that "a shareholder shall not have any right to obtain, *in the absence of fraud or fundamental unfairness,* an injunction against any proposed plan . . . or to claim the right to valuation of and payment of his shares . . . except that he may dissent and claim payment if and to the extent provided in section 515 of this act. . . ." 5 P.S. §1005 E (emphasis added). The Supreme Court of Pennsylvania construed this 1968 Amendment to the Business Corporation Law as a preservation, despite the exclusivity language in section 515 K, of the common law right of shareholders to enjoin proposed unfair or fraudulent corporate actions. *In re Jones & Laughlin Steel Corp.,* 488 Pa. 524, 412 A.2d 1099, 1103-04 (1980) (citing *Farris v. Glen Alden Corp.,* 393 Pa. 427, 143 A.2d 25 (1955) and *Weisbecker v. Hosiery Patents, Inc.,* 356 Pa. 244, 51 A.2d 811 (1947)). Thus the question presented is whether given the availability in Pennsylvania of suits to enjoin breaches of fiduciary duty, the Pennsylvania Supreme Court would construe section 515 K as prohibiting the other forms of relief such as rescission or money damages. To state the issue in terms with which corporate practitioners will be familiar: would the Supreme Court of Pennsylvania follow *Weinberger v. UOP Inc.,* 457 A.2d 701 (Del. 1983), the leading Delaware case on breach of fiduciary duty in a cash-out merger?

The defendants rely chiefly upon the Superior Court opinion *In re Jones & Laughlin Steel Corp.,* 263 Pa.Super. 378, 398 A.2d 186 (Pa.Super. 1979), which contains language possibly suggesting that the section 515 K appraisal right is exclusive of any other shareholder remedy. The holding of that case, however, is only that an appraisal court lacks jurisdiction to consider

the fairness of the underlying merger. Indeed the case was before the Superior Court at an interlocutory stage pursuant to 12 P.S. §672 (Purdon 1967), which affords an appeal from an order involving questions of jurisdiction. That jurisdictional holding was affirmed by the Supreme Court in *In re Jones & Laughlin Steel Corp.*, 488 Pa. 524, 412 A.2d 1099 (1980), but as we note above the Supreme Court took pains to point out that 15 P.S. §1005 E preserved shareholder remedies other than statutory appraisal. Moreover, although the *Jones & Laughlin* opinion on which the defendants rely was a section 515 post-merger appraisal suit, the underlying merger spawned, as here, a pre-merger shareholder class action seeking injunctive relief and/or damages. *Tanzer Economic Associates, Inc. v. Haynie,* 388 F.Supp. 365 (S.D.N.Y. 1974) (refusing to grant requested injunction), 405 F.Supp. 650 (S.D.N.Y. 1976) (refusing to dismiss complaint seeking damages). The Supreme Court of Pennsylvania noted the pendency of the *Tanzer* litigation, 412 A.2d at 1101, and by noting the propriety of a pre-merger lawsuit, preserved in 15 P.S. §1005 E, tacitly approved it. Eventually the *Tanzer* suit was settled, the settlement involved payment of damages, and in a subsequent stage of the *Jones & Laughlin* appraisal litigation the Superior Court made reference to it as follows:

> The *Tanzer* litigation is to be contrasted to the appraisal claim under the Business Corporation Law — Rights of Dissenting Shareholders, where the only relief available is a "judgment against the corporation for the amount of the fair value of their shares. . . ." 15 P.S. §1515(F). This limitation has been recognized by our Supreme Court in the present case upon prior appeal where it was determined that the appraisal remedy was the exclusive right which could be pursued in the present action. The court further recognized that dissenters could

> seek relief for unfair or fraudulent corporate actions in separate actions. See *In re Jones & Laughlin Steel Corp., supra,* 412 A.2d at 1103-04. Thus, our highest court has recognized in this very case that separate and distinct causes of action may be pursued as a result of the same purchase offer.

In re Jones & Laughlin Steel Corp., 328 Pa.Super. 442, 453, 477 A.2d 527, 532 (Pa. Super.1984). The unqualified statement about pursuing separate causes of action was made in the course of rejecting *Jones & Laughlin's* contention that by failing to opt out of the *Tanzer* class the appraisal plaintiffs were barred by *res judicata.* Thus it is a clear holding that in Pennsylvania the statutory appraisal cause of action coexists with common law causes of action. Indeed no other rule makes sense, for the appraisal remedy is available even absent misconduct of corporate officials. It was hardly enacted to provide a shield for such misconduct. We predict, therefore, that if faced with the issue the Pennsylvania Supreme Court would reject the defendants' interpretation of section 515 K as a bar to other causes of action for breach of fiduciary duty or misrepresentation in a cash-out merger.

Since the claim for breach of fiduciary duty by setting an unfair merger price was both separate from the federal non-disclosure claims and permitted under Pennsylvania law, the trial court erred in refusing to instruct the jury on that claim.

III

Other errors claimed by the shareholders would not in our view require a new trial but are addressed here since the issues may reoccur.

A.

The Directed Verdict on the Pricing Issue

[6] The shareholders contend that the proxy statement misrepresented the negotiations leading to the leveraged buyout by suggesting that the price was arrived at through arm's length negotiations, when in fact the terms and timing of the sales were dictated by Katz. The district court refused to submit to the jury the question of materiality of this alleged misrepresentation. J.A. 1211. Thus we must consider whether there was any evidence from which a jury could infer a material misrepresentation about the negotiations. The challenged language in the proxy statement reads:

> During the summer and fall of 1985 Mr. McCulloch indicated to Mr. Katz that he and other members of senior management were interested in structuring a leveraged buyout of Nutri/System. Preliminary efforts to determine the availability of financing were also initiated. In November and December 1985 further discussions took place among Mr. McCulloch and other members of the Investor Group and their advisors and Mr. Katz and his advisors.

Proxy Statement p. 23, J.A. at 1523. The shareholders claim that the jury would, or at least could, read this passage to imply that an arm's length negotiation took place, when in fact Katz made a take-it-or-leave-it proposal.

There are two difficulties with the shareholders' contention. First, the quoted passage does not refer to negotiations, arm's length or otherwise, but to discussions; a generic term which no more suggests arms length negotiations than it suggests self-dealing. Second, it is hard to imagine how a representation that arm's length negotiations took place between Katz and McCulloch would be material, in the required legal sense of importance to a reasonable shareholder in

making a decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed. 2d 757 (1976). The principal ingredient in such a decision is fairness of the proposed price, and the relationship between the history of the negotiations and the fairness of the price is on this record simply too attenuated. Thus the district court properly refused to submit the "negotiations" issue to the jury. With other evidence of record than that which we review the question might appear differently.

B.

Exclusion of Evidence of Post-Merger Performance

The shareholders sought to introduce evidence that Nutri/System's performance substantially exceeded the projections disclosed in the proxy statement during the first year after the leveraged buyout. Anticipating this evidence the defendants made a motion *in limine* to exclude it. The district court denied the motion without prejudice to its reconsideration, admitted it, but at the close of the testimony instructed the jury to disregard it. The shareholders contend that this ruling was error.

[7] The shareholders do not contend that evidence of post-merger performance is relevant to the fairness of the Connecticut National Bank fairness opinion. They urge, however, that it is relevant (1) for the purpose of proving management's pre-merger intentions, and (2) for the purpose of proving the value of the shares at the time of the buyout. Since the district court effectively withdrew the common law breach of fiduciary duty claim from the jury, the second possible ground of relevance apparently was not considered. The court's discussion appears to focus on use of the post-merger performance as evidence of management's pre-merger intentions or expectations. While the evidence may have met the rather low threshold of relevance under Fed. Evid.R. 402, *see Gerstle v. Gamble-Skogmo, Inc.*, 298

F.Supp. 66, 93 (E.D.N.Y.1969), *modified on other grounds,* 478 F.2d 1281 (2d Cir.1973), the court did not abuse its discretion in excluding it under Fed.Evid.R. 403 on the ground that the possible prejudice arising from use of events long after the preparation of the proxy statement to cast light on the defendants' earlier intention outweighed its limited probative value. *See, e.g., Rovegno v. Geppert Bros., Inc.,* 677 F.2d 327, 329 (3d Cir.1982); *United States v. Allessandrello,* 637 F.2d 131, 146 (3d Cir.1980), *cert. denied,* 451 U.S. 949, 101 S.Ct. 2031, 68 L.Ed.2d 334 (1981); *United States v. Long,* 574 F.2d 761, 767 (3d Cir.), *cert. denied,* 439 U.S. 985, 99 S.Ct. 577, 58 L.Ed.2d 657 (1978). Whether, on trial of the common law breach of fiduciary duty claim the evidence may be used to establish pre-merger value of Nutri/System is a different question. There is merit to the defendants' objection that post-merger performance is not a recognized method of proving value, at least absent evidence of obstacles to the use of other accepted methods of value such as market price, net asset value, and investment value. No such evidence appears in the present record.

C.

The Wording of the Special Verdict Interrogatories

[8, 9] The shareholders contend that the district court committed prejudicial error in formulating special verdict interrogatories Nos. 1, 2, 3 and 4. Under Fed. R.Civ.P. 49(a) they are deemed to have waived any objection to the interrogatories unless those objections are made known to the court before the jury retires. The record discloses no such objection to Interrogatories No. 1, 2, 3 and and 4. Thus we can consider the objections now only if they rise to the level of plain error. Moreover use and form of interrogatories is a matter for discretion of the district court. *McNally v. Nationwide Insurance Co.,* 815 F.2d 254, 266 (3d Cir. 1987).

The shareholders' first objection is to Interrogatory No. 1 which asks:

> Did the proxy statement contain a misrepresentation of material fact because it included the fairness opinion of Connecticut National Bank?

The shareholders contend that this question is misleading in that it might confuse the jury on the standard of fraudulence of an opinion rather than of a fact. Their own proposed question, however, is no clearer in elucidating the fact-opinion distinction. We find no plain error.

The second interrogatory asks:

> Did the proxy statement contain an omission of material fact because it did not include the projections developed by A. Donald McCulloch, Jr. that included his prediction that there was a 55 percent chance of exceeding published figures by 20 percent?

The shareholders claim that this question assumes that the projection referred to is attributable only to McCulloch, not to the entire management group. We do not see any such defect. The evidence suggests that McCulloch made the projection. The jury was free, answering the question as worded, to decide whether the management should have disclosed it. That appears to have been the understanding of counsel for the shareholders at trial. J.A. at 1195-96. We find no plain error.

The third and fourth interrogatories ask:

> 3. Does Exhibit P-24 accurately state a part of the contract between Connecticut National Bank and Nutri/System, Inc. concerning compensation to the bank for its services in rendering its fairness opinion?
>
> 4. Did the proxy statement contain an omission of material fact because it did not state the terms of the

contract between Connecticut National Bank and Nutri/System, Inc. set forth in Exhibit P-24?

The shareholders claim that somehow these questions removed from the jury's consideration two questions: what was the real fee arrangement; and was it adequately disclosed. In light of the fact that Exhibit P-24 states that $25 thousand will be returned if the leveraged buyout does not close we are at a loss to see any defect, let alone plain error.

D.

Jury Instructions

With the exception of the instruction on the pendent state law claim, which was preserved, the defendants failed to preserve objections to the district court's jury instructions. Fed.R.Civ.P. 51. None of the objections pressed on appeal can be so regarded.

IV.

[10] In its protective cross appeal Connecticut National Bank contends that the trial court erred in instructing the jury on the standard of liability applicable under section 14(a) to an outside professional such as an investment banker rendering an opinion in connection with a merger. Since we are remanding for a new trial, it is appropriate to address that contention. *Rhoads v. Ford Motor Co.*, 514 F.2d 931, 934 (3d Cir. 1975). The bank's specific objection is to the court's instruction that "the intent to deceive or cheat" was not necessary to establish its liability. J.A. at 1458. The bank specifically requested a *scienter* charge.

[11] *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976), which rejected the *scienter* requirement in cases under section 14(a), did not specifically address the liability of a bank that produces a fairness

opinion. *Gould* did, however, on policy grounds, distinguish section 14(a) cases from those arising under section 10(b), under which a *scienter* charge is required, *see Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). *Gould, supra,* 535 F.2d at 777-78. The *Gould* court analogized proxy statements to registration statements, both of which require careful disclosures to persons who are expected to act in reliance on the accuracy of those disclosures. *Id.* The test under section 14(a) is materiality of the disclosure. *TSC Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). A material misrepresentation even when made negligently rather than intentionally or recklessly, can still inflict the anticipated harm, and is thus deemed actionable.

[12] In asking us to depart from the *Gould* standard for outside advisers such as accountants and investment bankers, Connecticut National Bank relies on *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.) *cert. denied*, 449 U.S. 1067, 101 S.Ct. 795, 66 L.Ed.2d 611 (1980), which applied a *scienter* standard for an accountant who prepared a financial statement attached to a proxy statement. The reasoning of *Adams,* however, appears to be inconsistent with that of *Gould,* for it suggests that the *scienter* standard would apply in a section 14(a) case even for officers and directors. This panel is bound by *Gould,* which rejects the application of a *scienter* standard to such persons. Moreover since an investment banker rendering a fairness opinion in connection with a leveraged buyout knows full well that it will be used to solicit shareholder approval, and is well paid for the service it performs, we see no convincing reason for not holding it to the same standard of liability as the management it is assisting.

V.

The judgment appealed from will be reversed, and the case remanded for a new trial.

JAMES HUNTER, III, Circuit Judge: dissenting:

My colleagues would remand this case to determine whether defendant Connecticut National Bank (CNB) had a reasonable basis for selecting a 46% tax rate in calculating a five-year cash flow projection for Nutri/Systems. The parties do not dispute that use of the 46% rate was accurate under the tax laws as they existed at the time CNB gave its opinion. Thus, in rendering its fairness opinion, the bank did no more than rely on the law as it existed. Because I believe that CNB reasonably may rely on the law, I respectfully dissent.

The question before us is not whether the 46% rate was the only one that CNB reasonably could have chosen, but whether there was a reasonable basis for its choice. *Eisenberg v. Gagnon,* 766 F.2d 770, 776 (3d Cir.), *cert. denied,* 474 U.S. 946, 106 S.Ct. 343, 88 L.Ed.2d 290 (1985). The majority holds that CNB may have acted unreasonably in relying on the existing tax rate because Congress was then working on major tax reform legislation which would lower the top marginal income tax rate for corporations. CNB had a more than ample basis for choosing the existing rate. The tax rate on which CNB relied was the law; there was no other law due to take effect. At the time of the fairness opinion, the tax reform law still was being considered by a joint committee of the House and Senate. It had been passed by neither body, nor signed by the President. This fact alone provides a sufficient reasonable basis for CNB's choice of tax rate.

Even had the lower rate been ready to take effect, CNB's choice of rate would be reasonable. Tax reform was predicted to extend far beyond tax rates. As the majority notes, there was substantial uncertainty about what the "bottom line" effect of all the changes would be. I cannot agree with the majority, however, that the securities laws required CNB to speculate on all the intricacies and effects of major legislation. Further, the cash flow projections extended over five years. Given the

rising federal deficit and the several impending elections, CNB could not be certain that any lowered rate would not be increased within that five-year span. In the face of this uncertainty, the tax reform was being widely-publicized as "revenue neutral." This combination of factors provides CNB a reasonable basis to conclude that the existing 46% rate would not be far off the "bottom line" under the new laws.

I cannot agree that, by applying the law as written in making its projections, CNB acted without a reasonable basis for its opinion. I therefore dissent.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 87-1786-91
87-1798-1803

HENRY HERSKOWITZ, et al.

Appellants

v.

NUTRI/SYSTEM, INC., et al.

SUR PETITION FOR REHEARING

Present: GIBBONS, *Chief Judge,* SEITZ, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, and HUNTER,* *Circuit Judges*.

The petition for rehearing filed by appellees in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS
Chief Judge

Dated: October 11, 1988

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* As to panel rehearing only.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

HENRY HERSKOWITZ, et al.	:	CIVIL ACTION
	:	
vs.	:	
	:	
NUTRI/SYSTEM, INC., et al.	:	
	:	NO. 86-711, 86-712,
	:	86-725, 86-800,
	:	86-828 and 86-877

CIVIL JUDGMENT

Before Hon. Louis C. Bechtle

AND NOW, this 16th day of November 1987, in accordance with Interrogatories submitted to the jury and answers thereto,

IT IS ORDERED that Judgment be and the same is hereby entered in favor of the defendants Nutri/System, Inc., et al. and against the plaintiffs, Henry Herskowitz et al.

BY THE COURT:

ATTEST: MARIAN C. SCARENGELLI
Deputy Clerk

STATUTES

15 U.S.C. §78j Manipulative and deceptive devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

15 U.S.C. §78n Proxies

"Solicitation of proxies in violation of rules and regulations

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title."

REGULATIONS

17 C.F.R. §240.10b-5. "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made , not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

17 C.F.R. §240.14a-9. "(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the soliciation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation."